S. HRG. 101-684

THE GENERAL ACCOUNTING OFFICE'S AUDIT OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE RESULTS OF THE GAO FINANCIAL AUDIT OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION'S [FSLIC] FINAL FINANCIAL STATEMENTS DATED AUGUST 8, 1989. THESE STATEMENTS SUM UP THE KNOWN FINANCIAL LOSSES OF THE SAVINGS AND LOAN INDUSTRY CRISIS TO FSLIC

APRIL 6, 1990

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THE GENERAL ACCOUNTING OFFICE'S AUDIT OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

FRIDAY, APRIL 6, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Graham, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. I have, in a moment, an opening comment that I want to make. Our witness today is Charles Bowsher, who is the Comptroller General of the U.S. General Accounting Office. We have had the pleasure of hearing Mr. Bowsher here before. I think he does an outstanding job.

When I look around Government at the people who I admire most for their dedication to public service and their consistent completion of difficult work over a period of time done objectively to very high standards, I think of you, Mr. Comptroller, very high on a small list.

And so we are very pleased to have you here today.

The hearing today is on the General Accounting Office's final audit of FSLIC, the Federal Savings and Loan Insurance Corporation.

Until last year, FSLIC was the deposit insurer for the savings and loan industry. As we know, last year's thrift legislation created a new thrift deposit insurer, abolished the FSLIC, and required it to present a final financial statement to Congress within 60 days, which it did.

One of the key issues we face now is how much it will cost the Government to wind up FSLIC's financial affairs.

Last year, we were repeatedly assured by the administration that $90 billion of incremental spending would do the job. The FSLIC Resolution Fund, administered by the FDIC, would need $40 billion to take care of old cases whose resolution was underway.

In addition to that, the Resolution Trust Corporation would need another $50 billion to handle other insolvent thrifts.

But, as I now study the reports that have been prepared for us, and Mr. Bowsher will go into those, the GAO has now concluded that the FSLIC Resolution Fund will need apparently an additional

$12 billion and the Resolution Trust Corporation will need an additional $50 billion.

It is hard to keep track of all of these figures on a comparable basis.

If we interpret it correctly, and I want to ask the Comptroller General to address this question, a 33-year timeframe—the timeframe over which all of the payouts were to have been administered, was a timeframe that covered the originally anticipated time scope of the problem. Using that timeframe the original estimates were that it was going to cost, over the full 33-year period, a figure of approximately $257 billion.

I am told now that that figure is now estimated at $325 billion and even that figure may not capture the full extent of the problem. The final figure may be higher than that.

Sometimes we talk about the full time period for resolving this problem as 33 years. Sometimes we talk about a 10 year timeframe; sometimes a 3-year timeframe; sometimes, we use a 1-year cost. It is easy to become confused as these numbers get moved around. We need to be very specific about the time period we are using in order to have some truly comparable way of measuring the degree to which the cost estimates are rising.

Even after these adjustments that I have just cited, the GAO has given FSLIC only a qualified opinion because of "significant uncertainties"—here I quote GAO's own phrase—about the ultimate cost of dealing with insolvent thrifts.

In addition, I would imagine that even these GAO estimates may very well be on the conservative side. We may find that actual experience produces an even higher cost.

In addition to reporting on its audit of FSLIC, the GAO will discuss its recent recommendations to the Treasury Department on deposit insurance reform. In particular, the GAO wants the accounting profession to take a more active role in identifying fraud and mismanagement in federally insured banks and thrifts. GAO suggests that accountants should share information with examiners and work in tandem with the regulatory process.

The Comptroller is asked to testify before many committees. In fact, he has told me that he has to appear before another committee at 11 o'clock this morning. We will be mindful of that time constraint so that he is able to leave on time.

If we have additional ground to cover, his staff will stay to address it.

So, Mr. Bowsher, we are pleased to have you before us this morning and I welcome your statement at this time.

Before we begin, I have statements from Senators Sasser, Sanford, and Graham for insertion in the record.

[The statements follow:]

STATEMENT BY SENATOR SASSER

Senator SASSER. I'm pleased that the Comptroller General of the United States, the Honorable Charles Bowsher, will deliver to the committee today the results of the GAO's audit of FSLIC's final financial statements. I also welcome his views on the overall financing requirements of the bailout.

I say I'm pleased that he's here, but I'm also a bit nervous . . . I suppose the way I am when I bring my 1970's vintage car to the mechanic for a once-over—grateful for the inspection, but fearful of what might be turned up.

Closing the books on FSLIC means owning up to the largest losses ever reported by a public or private corporation. And it is a far-reaching tragedy.

Nearly a full year after drafting and passing FIRREA, we still live with troubling questions about the magnitude of the S&L problem. Until now, we have been without an accurate accounting of the full scope of assets dragged down when FSLIC capsized.

Looming questions remain about the long-range extent of the RTC's needs, and importantly, about the timing of those needs. Without a clear plan from the administration—a plan that goes out at least 5 years, and preferably 10—uncertainty will continue to hover over the bailout effort.

The adage that time is money is made literal by this crisis. The RTC places the combined daily operating loss for S&L's in conservatorship at $14 million a day, though I've seen estimates as high as $29 million a day. CBO and the FDIC are projecting that an additional 200 to 300 S&L's will fall into insolvency in the next 3 years. Failures at that rate will add an additional $25 to $30 billion to the bill.

We're attempting to drain the swamp, yet the flood gates are still open. And the forces keeping them open are monumental—from the painfully slow pace of resolutions, to dismal fourth quarter S&L income figures, to a disappointing economic scenario predicated on growth in deposits that clearly doesn't exist.

Mr. Chairman, despite these problems, at the very least we owe the taxpayers a bailout program that is free of the weak controls, the bad paperwork, and the regulatory lapses that precipitated the crisis itself. A thorough GAO audit of FSLIC and a commitment to annual audits of the RTC are certainly steps in that direction.

I look forward to hearing the testimony of Mr. Bowsher and his staff.

Thank you.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Mr. Chairman, I thank you for calling for this hearing and I welcome Mr. Bowsher to this committee. It is always helpful to hear the careful and thoughtful testimony of Mr. Bowsher and I thank him and the staff at GAO for their fine work.

However, as our colleague Mr. Dixon noted at our recent hearing on Glass-Steagall, I can't really say that it is a pleasure to be here. Indeed, it is with considerable frustration and a tremendous sense of deja vu that we appear this morning to listen to another report on the fact that the S&L problem and costs facing the RTC are greater than we anticipated or had ever been told before.

It was just a year ago that the President presented his plan for resolving the thrift crisis to this committee. That plan called for $50 billion in funding for the Resolution Trust Corporation. We were told then by Treasury Secretary Brady and others that the $50 billion was sufficient and included some cushion for the resolu-

tion of the current caseload. Now you have the unfortunate task, Mr. Bowsher, of appearing before us to tell us again that the $50 billion is not enough, that at least $68 billion in additional funds will be needed, and that the total cost for resolving the FSLIC problem is now $325 billion.

Perhaps most troubling are your statements that the RTC's costs to resolve its current caseload will be much higher than estimated. I find that especially troubling because I think some of the additional costs are due solely to delays in resolving cases, and in part because it reflects the tremendous problems the RTC is having in attracting bidders. These difficulties may mean that additional incentives will be needed to encourage others to purchase the RTC assets. Such incentives undoubtedly will cost the taxpayers more money.

I appreciate your willingness to appear before us today, even if it is to be the bearer of bad news. I look forward to your testimony and to working with the GAO and others to implement some of your suggestions that will help us and the taxpayers keep a closer tab on how all of these funds are being spent.

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator GRAHAM. Mr. Chairman, on January 31 of this year you started the committee hearing schedule with the oversight hearing on the Resolution Trust Corporation. Starting with this issue demonstrates this committee's priority on the savings and loan crisis.

Today's hearing with the GAO appearing to discuss their final FSLIC audit and to present the size-of-the-problem estimates is important as another piece of the committee's oversight priority. This was brought to my attention yesterday, when the staff was trying to get the most current numbers for the size-of-the-problem for use in my floor statement on the nomination of the Director of the Office of Thrift Supervision. It was almost impossible to get current numbers from either the RTC or the OTS. We were never sure whether they were both counting the same institutions once, twice or not at all. We ended up relying on January numbers. As you know the RTC must rely on the OTS to idenify institutions it expects may eventually come to the RTC. So I hope the GAO will be able to help us straighten out the numbers.

As you know the total cost of the bailout continues to be, as it was in 1989, one of my major concerns. Mr. Bowsher's testimony will discuss whether the cost will be more than we anticipated, and more than last year's bill provided.

We want all the numbers available to be able to judge the impact of the costs. Let me illustrate: Chart I shows the economic assumptions made by the Treasury Department and OMB in January 1989 when Secretary Brady and OMB Director Darmen introduced their plan to assist the savings and loan industry; and chart II shows the actual economic percentages for 1989 and CBO has projected what the percentages will be for the out years.

FICO rates were projected to be 9.8 percent. Actually they were 9.2 percent REFCORP rates were projected to be 9.1 percent in 1989, 7.9 percent in 1990 and 6.5 percent in 1991. Actually they are 8.4 percent and projected to be 8.1 percent in 1991; 30-year 8.125

percent in October 1989 was $4,522,068,000—currently 9 percent in April 1990; 40-year 8.625 percent in January 1990 was $5,002,232,000—currently 8.92 percent in April 1990.

Interest rate on LT treasuries: 1989—10 year 8.8 percent, 30 year 8.7 percent; 1990—7.9 percent, 8.1 percent; 1991—7.7 percent, 7.9 percent; and 1992—7.7 percent, 7.9 percent.

These charts highlight the changes from the January 1989 Brady economic projections to the actual 1989 indicators as of April 1990. They also highlight the cost increases for the bailout. To go back to my example on the REFCORP bonds the interest costs on $9½ billion in bonds is $28,349,241,150 which is an additional $4 billion over 10 years.

Mr. Bowsher, I am concerned about the cost. I do not look forward to hearing how much the cost to the taxpayer may have increased.

ADMINISTRATION ECONOMIC ASSUMPTIONS FOR THE SAVINGS AND LOAN BILL, JANUARY, 1989

($ in Trillions)

Assumptions	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	
FICO (CEBA) Rates	9.8 %	8.6 %			wtd avg (88-90):		9.5%
REFCORP Rates	9.1 %	7.9 %	6.5 %		wtd avg (89-91):		7.7%
Int Rate on LT Treasuries	8.8 %	7.6 %	6.2 %		wtd avg (89-91):		7.4%
Discount on Zeros	8.8 %	7.6 %	6.2 %		wtd avg (89-91):		7.4%
Int Rate on FSLIC Notes	9.5 %	7.8 %	6.1 %	4.9 %	4.3 %	4.0 %	
FSLIC Deposit Base	1.0	1.1	1.2	1.2	1.3	1.4	
1989-99 Growth Rate	7.2 %						
FDIC Deposit Base	2.1	2.3	2.4	2.6	2.8	2.9	
1989-99 Growth Rate	6.9 %						

Recovery on receivership assets (new cases):
40 cents on each dollar over the 4 years subsequent to liquidation

ACTUAL ECONOMIC ASSUMPTIONS AND CBO PROJECTIONS

Prepared April 4, 1990.

Economic Assumptions by Fiscal Year	Acutal 1989	CBO February Projections 1990	1991	1992	1993	1994
FICO RATES	9.2%	(a)				
REFCORP RATES	(b)	8.4%	8.1%			
Interest Rate on Long Term Treasuries						
10-Year	8.8%	7.9%	7.7%	7.7%		
30-Year	8.7%	8.1%	7.9%	7.9%		
Discount on Zeros		7.7%	8.1%			
Interest Rate on FSLIC Notes	8.6%	7.9%	7.7%	7.7%	7.3%	7.0%
FSLIC Deposit Base (c)	0.9	0.9	0.9	0.9	0.9	0.9
1989-1990 Growth Rate	-1.0%	-1.0%	-0.5%	-0.3%	0.0%	0.0%
FDIC Deposit Base	2.1	2.3	2.4	2.5	2.6	2.8
1989-1990 Growth Rate	5.2%					

(a) FICO issues no longer being done.
(b) First REFCORP issue was completed in fiscal year 1990.
(c) FIRREA changed the definition of deposit base for purposes of calculating assessment income. This is partly responsible for the decline in deposit base as shown in the table.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT DIVISION; DONALD H. CHAPIN, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION; AND ROBERT GRAMLING, ISSUE DIRECTOR

Mr. BOWSHER. Thank you very much, Mr. Chairman. It's a pleasure to be here today. I'd like to introduce my colleagues, Mr. Fogel on my right, Assistant Comptroller General of our General Government Division; and on my far left is Don Chapin. He's the Assistant Comptroller General for our Accounting and Financial Management Division. And Bob Gramling is the Issue Director who headed up our audits on FSLIC over in the last few years and did this final one.

I'd like to just read the first paragraph of my statement on page 1, and then I'm going to summarize most of the rest of the statement.

This is our final audit of the Federal Savings and Loan Insurance Corporation, or FSLIC. In other words, FSLIC went out of business as of August 8, 1989, and it issued these final statements for the period January 1, 1989 to August 8, 1989.

For the 7 months ending August 8, 1989, FSLIC reported a net loss of over $13 billion. This loss is in addition to its $66 billion loss in 1988 and another $21 billion in losses it incurred from 1984 through 1987.

After losing $100 billion since 1984, FSLIC now closes its books with a capital deficit of $87 billion.

And I might point out, Mr. Chairman, this is the largest ever reported by a public or private corporation.

FSLIC's financial statements raise the important issue of how much money will be needed to resolve the savings and loan industry crisis, which is now what I will address. And I would draw everybody's attention to the chart over here. And it is also the last page of the testimony.

And as you pointed out, Mr. Chairman, last year, based on the OMB estimates and assumptions, the estimate of what this would cost over the life of the program, which at that time was estimated to be 30 years because they were going to sell 30 year bonds, the final figure was $257 billion.

We now believe it's going to cost at least another $68 billion, and that's broken down by the five categories there. The first one is the additional funds that are needed for the FSLIC assistance transactions.

Now, that's the 1988 and December deals that, literally, Danny Wall did, and that estimate now goes from $56 billion up to $68 billion, or adds another $12 billion.

Then, on the failed but unresolved institutions that RTC will handle that estimate goes from $50 billion to $63 billion, so that's up by $13 billion.

Then, we have to add administrative expenses which, because all the costs in the original $50 billion is going to be used for resolution, we now have to have an estimate which RTC has provided for

what the administrative costs are going to be. And that's $10 billion.

And I might just break that down on an annual basis for you, Mr. Chairman. That's salaries of $200 million, legal fees of $259 million and $973 million a year for asset management for the key components of the $1.6 billion annual basis.

Then we have the interest on the RTC working capital. That's $28 billion. And an additional REFCORP interest expense of $5 billion.

So that's what makes up the $68 billion. And as, again, Mr. Chairman, you pointed out and we want to stress very much, that's the minimum funds needed. We have to give a subject to opinion, which is not a complete opinion, on this financial audit. And that means that you could have additional losses later on and additional requirements for more money.

The CHAIRMAN. Now, let me stop you right at that point. The baseline estimate that was done in July 1989, that was about 8 months ago. So, 8 months of time has passed to provide the basis for this update.

Mr. BOWSHER. That's right.

The CHAIRMAN. And we now see this increase in the estimated cost.

Are we to assume if we take another reading 8 months from now, that we could see a further upward movement in these projections?

Mr. BOWSHER. We could see an upward movement of these projections. And one of the things we've recommended in our report to you is that the Congress request a semiannual report from the Chairman of the Oversight Board and the head of the FDIC, which includes the RTC, so that you know on a semiannual basis just where things stand.

In other words, this is a fast-moving target, a fast-moving situation, taking over all these S&L's and trying to work out the assets. And as we said a year ago, there were some estimates in there that worried us and that's why we're back here today listing a sizable increase.

And if you remember, in OMB's estimates they had used an interest rate that I thought was low at that time and has proven to be low. We're still using I think interest rates that are not as high as what we are currently having to pay for Fed funds.

And if the interest rates go higher, of course, that could certainly add to the problem.

We also, if you remember, a year ago, had estimates that everybody insisted on continuing to use in the assumptions, that there would be a deposit growth here in this industry based on a 10-year average which gave you a 7-percent increase in deposits.

And at the time, we saw the deposits flowing out. And that still is a big issue. I think the biggest issue though really that can drive this number higher is how many S&L's are really going to fail and have to be taken over by the Government? And then, what is the quality of the assets the Government has taken over and how are they able to dispose of them?

Those are the main components that can drive it higher.

There is no question that this could easily go to $400 billion if more S&L's fail and the asset quality continues to be as bad as some of the ones that they've already taken over.

And I think also, you know, we've had a strong economy during this whole period. If we ever get the economy working against us, where the interest rates either go up much higher or if you have a recession, the estimates today could go as high as $500 billion or a half a trillion dollars, that could be possible, unfortunately.

The CHAIRMAN. Senator Graham from Florida has just joined us. I don't want to break the continuity of your presentation, but this very issue of what could cause the costs to rise further is important. Am I correct in concluding that, if the economy were to go into a tailspin and work against us, it could drive these numbers up much higher?

I take it that any further decline in real estate values could well cause these numbers to balloon to even a greater size.

Am I right in that?

Mr. BOWSHER. You're absolutely correct on that point.

The CHAIRMAN. And are we seeing continued softening of real estate values?

Mr. BOWSHER. That appears to be the trend. And not only in some of the areas that, say, a year or two we were looking at, like the Southwest and that, but now in the Northeast and in some other parts of the country. Even here in some suburbs of Washington, we are seeing some softening of the market.

So there's no question that the issue of how strong the real estate market is could play into how large a cost this program ultimately is.

The CHAIRMAN. Please go ahead with your summary points. When you finish, I will call on Senator Graham to make any initial comments he wants to make.

Mr. BOWSHER. All right, Mr. Chairman.

In our statement, we have gone through again what we think are the major causes of the savings and loan association problems. They aren't too much different than what we reported to the committee last year, but I will point out that you asked us to look at certain situations. And we have looked at those situations and we've made referrals to the Justice Department.

In other words, we have found one more time some potential fraud, potential problems, and we have reported those cases over to Justice for further review.

The CHAIRMAN. Very good.

Mr. BOWSHER. I think it's significant. There's a paragraph on page 13 of my statement where I point out that the RTC Chairman has recently testified that about 60 percent of the RTC-controlled institutions have been victimized by serious criminal activity. He said that RTC plans to have a staff of 300 investigators by the end of the year to help determine whether and what action should be initiated against individuals who caused savings institution insolvencies through their negligent and reckless mismanagement, fraud or criminal conduct.

And he noted that over 1,200 criminal referrals have been sent to the Justice Department naming insiders, borrowers or agents of RTC-controlled institutions.

I think that sums up the terrible situation we have in this S&L crisis.

The CHAIRMAN. Let me interject on that point, and I'll invite Senator Graham to do so, too.

In the legislation, the administration asked for $50 million a year for each of the next 3 years for purposes to hire lawyers over at the Justice Department to track down the crooks and to bring them to Justice and to recover some of the lost funds.

The Congress increased that figure from $50 million a year to $75 million a year for each of the 3 years. We have been now told that the administration has decided to only spend the $50 million and not the full $75 million that we made available.

I would infer from what you have said here that, in fact, there's enough work to be done out there so that the full amount is needed.

Can the committee correctly infer that we need more lawyers tracking these folks down to obtain more recoveries and prosecutions?

Mr. BOWSHER. Yes, Mr. Chairman. In other words, our investigators have been out in the field and they feel very strongly that more FBI agents, lawyers, and investigators who deal with white collar crime are needed. These resources have to be out there to really track down the number of people that should be examined and reviewed in this situation.

So we strongly support that.

The CHAIRMAN. Senator Graham, do you have anything on this particular point before we proceed?

Senator GRAHAM. Mr. Chairman, I appreciate your calling this hearing today. And what Mr. Bowsher said 5 minutes ago, that this could become a $400 billion disaster—is that a correct statement, sir?

The CHAIRMAN. He said that it could easily become a $400 billion problem. And it might even hit as high as $500 billion or a half trillion dollars if you get the economy working against you.

Senator GRAHAM. That is a devastating statement as to the severity of the problem with which we are faced, and I think should be a call to arms for all people involved, from the administration to the Congress to the industry to take whatever actions are necessary in order to suture this hemorrhaging financial condition.

Mr. BOWSHER. Senator, if I could also just point out, because sometimes people have a hard time relating to all those billions of dollars. But I often used to say that this is going to be big enough and serious enough that it's going to be bigger than all the bailouts—New York City, Chrysler, Lockheed—put together.

You know, we passed that figure up. And then I used to say this is going to be bigger than the Marshall Plan. If you inflate the Marshall Plan dollars of the late forties, you get up to something like $60 some odd billion from around $14 or $15 billion.

Well, you can see now we've passed that.

The CHAIRMAN. Several times over.

Mr. BOWSHER. And I notice some reporter this morning pointed out that, you know, this is bigger than the annual budget of the Defense Department now, when you go past the $300 billion mark.

So we are looking here at a huge—huge—number as far as what the American taxpayer is going to have to pay.

And I think also, last year, there was some feeling that the industry could pay quite a bit of this. But, as you can see, the industry is deteriorating here as far as the number goes. And I would suspect in most of these add-on numbers that we are going to have to lay out here, the $68 billion that we're laying out today and any additional ones that we might lay out in the next year or two, that's mostly going to be taxpayer money.

Senator GRAHAM. Mr. Chairman, I have an opening statement which I would like to file for the record, but within that, I had raised those issues. And I wonder—do you have the charts?

I was concerned last year at the economic assumptions upon which the Treasury's plan was based and particularly what they inferred in terms of the allocation of ultimate costs as between the industry and the general taxpayer.

My premise was that the economic assumptions were unrealistic and the consequence of that lack of reality would be that the taxpayers would pay a higher portion of whatever the ultimate cost was than was being projected.

The numbers that we have indicate that, for instance, on the assumption as to what the Federal Government would have to pay in order to finance the REFCORP bonds—these are the bonds that were 60 percent off budget pursuant to last year's act—that the Treasury had projected that they would be 9.1 percent in 1989, 7.9 percent in 1990, and 6.5 percent in 1991.

Actually, in 1990, instead of being 7.9 percent, they were 8.4 percent. And instead of the projection now being 6.5 percent in 1991, the projection for 1991 is 8.1 percent.

That one statistic and the others which are included in my statement cumulate to the result that it's now estimated that the taxpayers, as opposed to the industry, will be picking up at least an additional $4 billion in interest cost during the period from now until the year 1999.

Mr. Chairman, I would hope that this committee would take the report that we have just received, as well as the results of other hearings on this issue. And at the earliest possible time call to this committee those responsible for the various agencies, including OTS, RTC, FDIC, to present their plan as to what will be done to reduce the ultimate cost to the American taxpayer and what recommendations they will have that will require congressional action, and that we give the earliest possible attention to those recommendations.

The CHAIRMAN. I fully agree with you, Senator Graham. My thinking runs along the same lines. We have, of course, a newly confirmed Director of the OTS who has to literally get into his new job. I presume he is doing that as we speak.

Within a very short period of time, we will ask that Director and the others you cite to come here to respond to this changed financial picture, and to answer our questions on what they intend to do.

How are they coping with the problem?

What plans do they have to deal with it?

And what implications should we consider and take account of?

We have been joined by Senator Pressler. After you have finished the summary from your full statement, which we are making a part of the record, I will call on Senator Pressler for any opening comments. And then we will go back into these individual issues.

OPENING COMMENTS OF SENATOR PRESSLER

Senator PRESSLER. Thank you very much, Mr. Chairman. Since the General Accounting Office has completed its final audit of the now liquidated Federal Savings and Loan Insurance Corporation, I shall be very interested to hear today's testimony of the Comptroller General. It confirms that we are in a very sad situation costing taxpayers billions and billions of dollars.

Thank you, Mr. Chairman.

The CHAIRMAN. Just before you arrived, Senator Pressler, Mr. Bowsher indicated that the cost, which has now been rising according to GAO's best estimates, could easily reach $400 billion. And it's entirely within the realm of possibility that it might go to a half a trillion dollars.

Mr. Bowsher, why don't you now continue with your summary points.

Mr. BOWSHER. All right, thank you, Mr. Chairman.

The last major area really is one of the areas that you touched on, Mr. Chairman. That's the accounting and auditing issues. We really do feel that in the last legislation that was passed by the Congress, they did not include strengthened auditing procedures. We think that is necessary at sometime in the future. We think the internal controls have got to be looked at more closely by the regulators and by the outside auditors.

And we also think the same with compliance of safety and soundness laws and regulations.

As part of the FIRREA legislation, we were asked, along with others, to send a letter to the Treasury Department commenting on this issue. And we did so. We recommended the same recommendations that we had made last year at the time of the legislation.

And we also were asked to discuss what's known as the Bank of England regulations, that they have imposed on their auditors in England. We pointed out that the overall thrust of their regulations, which means better communications between the auditors and the regulators, is something that should be considered here and should be studied. Because we do believe that, as you look at these failed financial institutions, not only with the S&L's but with some of the banks that have got into financial trouble, the regulators could have benefited by knowing more about what the auditors were finding. Also the auditors certainly could have been in a better position on their work if they were fully conversant with what the regulators were finding with some of these troubled situations.

So that pretty much concludes my prepared statement summary, Mr. Chairman, and we'd be happy to answer any questions here.

The CHAIRMAN. I want to ask you several things.

The first question concerns the 1988 deals that we have talked about a number of times.

Mr. BOWSHER. Yes.

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The CHAIRMAN. You will recall that I sent you a letter asking you to reconstruct what had happened and evaluate it.

I know you had worked on the audit.

Where does that stand at the present time?

Mr. BOWSHER. I'm going to ask Mr. Fogel to answer your question because it's his group that has been doing that work.

Mr. FOGEL. There were several requirements. We are going to finish our initial part and report, hopefully, by the end of this month, on the extent to which RTC and the FDIC went in quickly enough and began the process of monitoring the complex relationships in those deals.

We reported preliminarily in January that they weren't on top of that. They hadn't staffed up enough. They hadn't developed plans to really go in and monitor how the business plans were being developed, how all those S&L's were going to develop strategies to sell the assets.

Since that time, they have gotten up to speed more.

In addition, the RTC and the FDIC have let contracts and will have information later this summer that will show the extent to which the Government may want to exercise certain options in the contracts to buy out some of the notes, and those deals.

So we'll have a complete picture on those by the end of the summer.

The CHAIRMAN. May I ask whether we know enough at this point to say whether there are any troubling observations that you are finding in the course of this work?

Mr. FOGEL. Well, we are. As Mr. Bowsher noted, we have made some referrals for criminal prosecution to the Justice Department. Some of those referrals were as a result of activities that went on in the 1988 deals. So our own investigators were able to uncover things that, in effect, substantiate some of the allegations that Mr. Seidman has made and as we have reported earlier, that there was fraud involved in these activities.

The CHAIRMAN. And so there are some number of instances in which referrals, formal referrals, have gone over to the Justice Department?

Mr. BOWSHER. That's correct, Mr. Chairman.

If I could just add something to what Mr. Fogel said. And that is, if you will remember, those deals were done in December 1988 in a great rush and the people on both sides of the table, I always felt, didn't know what they were really dealing with.

And we said that you'd have to do audits to find out where everything stands.

And what Mr. Fogel is really saying today is those audits haven't been completed. And until those audits really get completed, you're not going to know where things stand.

And so I think it's awfully important that work be completed and then we will be reviewing it.

The CHAIRMAN. Now, I appreciate what you have just said. There was concern about this issue, so it is important to do it right. But this issue has now been raised and I don't want to leave it hanging.

I take it that some of the criminal referrals that you have referred to come out of your assessment of the December deals?

Mr. BOWSHER. That's correct.

The CHAIRMAN. OK. Have other criminal referrals, unrelated to the December deals, been sent over?

Mr. BOWSHER. Yes, they have.

The CHAIRMAN. Are more in the works?

Mr. BOWSHER. We have pretty much completed our investigative work where we think there are those kind of problems.

The CHAIRMAN. Do you need any additional resources or staff to scrub this topic from A to Z?

Mr. BOWSHER. No. I think at this point it's important that the Justice Department and the FBI take over because they have subpoena powers and some powers to require some disclosures that we don't have. So I think it's better that they take over the issue.

The CHAIRMAN. It is very interesting to hear that because, Senator Graham has expressed an interest in this subject over a period of time. In December 1988, we were in the midst of a change in this committee. Senator Proxmire retired and I was the incoming Chairman.

I was concerned about the pattern of these deals which did not seem right. So we requested that work to be done.

And it sounds as though the work has yielded some important results here.

We will be interested to hear exactly what they are, in due course.

Senator Graham, let me invite you to question at this point.

Senator GRAHAM. Thank you, Mr. Chairman.

At the January hearing of this committee, Mr. Robeson, Mr. Kemp, Mr. Greenspan and Mr. Seidman all commented about the fact that, if there were not enough resources to handle the responsibilities which they had been given collectively and individually, that they were urged to come back to the committee with a request for additional resources.

At the time, it was their feeling that they felt they had sufficient resources.

Your testimony indicates that, at a minimum, there is now a shortfall of $68 billion.

What do you think will be the consequences of delay in providing the additional resources?

Mr. BOWSHER. Well, I think that delay can always cost more money because that's really what's tended to drive this problem even higher as it has been delayed over the last couple of years.

But we really can't give you a firm estimate, Senator, on just when the RTC is going to need more money. In other words, there's no question in my mind they are going to need more money. And that's why I had earlier said to the chairman that you need a cash flow from the RTC and the Oversight Board. And we are recommending semiannually reporting by them to the Congress as to where do things stand, so that these issues can get worked out.

There's just no question that more money is going to be needed here.

What the timing of it is I'm just not sure, and that's what they should lay out. And then we could review it if you would like us to review it at that time.

Senator GRAHAM. One of the issues last year was the question of how the financing of this should be provided, whether it should be an on-budget item or off-budget.

Do you have any recommendations relative to the additional funds that they're going to be providing?

Mr. BOWSHER. Well, we were strong last year for having it on-budget. And if you had to change the targets of the Gramm-Rudman, that was what we thought should have been done.

I think, going back to the chart that you put up there, one of the reasons you need to use realistic interest rates and other assumptions is because everybody is still trying to meet the Gramm-Rudman targets with these kind of issues.

And I think you kid yourself. And that's why you're back a year later saying that we need another X-billions of dollars. It's kind of like a weapons system over at the Pentagon.

I mean, people kid themselves. And then, next year, you have to come back and report a cost overrun. And so I feel that we've got to get these kind of problems on-budget and we've got to face up to the facts as to how bad the situation is, pushing it off and dealing with it on an annual basis.

I think you've got a tough situation here this year in the mid-point review by OMB when they have to come up and state how much they're—what the budget situation is for Gramm-Rudman. I think they should have a realistic number in there for the savings and loan problem.

The CHAIRMAN. Please yield briefly on that point.

What we may do when we get that estimate, and if it seems as unrealistic as the original estimates, we may ask you to do a quick, independent appraisal and give us your best judgment.

Mr. BOWSHER. All right.

The CHAIRMAN. So that we have an arm's length, side-by-side comparison of the estimated costs.

Excuse me, Senator Graham.

Senator GRAHAM. I agree with that statement, Senator Riegle. And given the fact that the budget resolution supposedly is to be adopted by the 15th of April—that's a target that's not going to be met, but, assumedly, it will be shortly thereafter—if this is to be financed on-budget, we need to know very expeditiously what amount will be required so that provision can be made in the budget resolution for that purpose.

A second item of urgency that concerns me, and I'm using some information from Florida, but I would be curious as to whether this is indicative of what's happening elsewhere, and that is:

We are back in the pattern that we saw in the 1988 period. And that is that the weak institutions are competing for deposits by offering interest rates that are substantially ahead of the market. Therefore, imperiling the solvent institutions who have to compete.

For instance, one of the largest institutions to go into Federal Conservatorship is Syntrust Bank, based in Florida. It was the largest thrift institution in the Southeast.

The Miami Herald, in its March 5 report of the savings accounts yields, indicates that for south Florida thrifts, the average on 3-month CD's, for example, was 7.82 percent as compared to a national average of 7.72 percent.

But, the highest offered among some 15 or 20 institutions in south Florida was Syntrust at 8.22 percent. So Syntrust was offering about 40 basis points above the south Florida average and 50 basis points above the national average, of the highest in the south Florida region. It clearly is a means of attracting depositors to an institution that's been under a lot of stress.

I wonder if this pattern has been typical of other regions of the country?

Mr. FOGEL. Well, we know that there have been institutions that have become weaker and are trying to advertise higher rates. That's one of the reasons the RTC is beginning to move out quicker and trying to put institutions into conservatorship or thinking about some other ways, so that you can replace the high cost of those funds quicker.

We believe that FDIC has estimated so far they're saving around $250 million a year in expenses by being able to replace high-cost funds.

But that's what could drive up the estimate more. If you look at the amount of money that will be needed to resolve institutions, if you go in and you want to replace high-cost funds quickly, you need more cash up front to do it.

So, hopefully, in the end, you can save some money.

But, as the institutions deteriorate, that, unfortunately, is one thing they have to do.

Senator GRAHAM. One thing that's going to be fundamental to the confidence of the American people and the Congress in this process is consistency of data reporting. If there is a pattern of different information coming from supposedly knowledgeable sources, that raises a question not only about the data but about the confidence of the people who are producing it.

Our office had an experience last week as we were preparing some remarks on the nominee for the Director of the Office of Thrift Supervision. We were attempting to get data on the current numbers of institutions in different categories of distress and the deposit of those institutions. And we found that there was no consistency between the information provided by the RTC and OTS.

I would hope that one of the contributions that your agency might make would be to encourage the establishment of consistent definitions and reporting standards so that there will be a commonality of information.

I have used the quotation that is attributed to Mr. Alan Greenspan at the opening of the Social Security group in 1983 in which he said that there was going to be one standard for the work of this Commission. And that is that:

Everyone was entitled to their own opinion; nobody was entitled to their own facts.

I believe that, in this situation, we have had a lot of people who have chosen to use their own facts in order to support their own opinions.

Mr. BOWSHER. Senator, that's one of the reasons we are calling for semiannual reporting by the Oversight Board and the RTC. And we think that we should be reviewing those reports, as I believe the Congress asked us to do, in monitoring the RTC. And

we're even going to be reviewing the systems that are being designed so that, hopefully, there is that standardization in there.

So we'll work very hard to see that your wishes, which are very reasonable, should be carried out there.

Senator GRAHAM. I would just conclude with one additional request that might be incorporated in that semiannual report, and that is an assessment of the assumptions upon which projections have been made, because this is very much of a video tape we're dealing with and it's a moving situation. And we are interested in what the next frames of the video tape are going to be, which are largely predicated on assumptions of what various economic factors will be.

So I think that, at least on a 6-month basis, we ought to have a review of the accuracy and continued usability of the past assumptions upon which policy was predicated.

Mr. BOWSHER. I agree with that.

The CHAIRMAN. We are mindful of the fact that you have another committee to testify before at 11. We will continue past that time with your staff.

Before I go to Senator Pressler, I want to make sure that I understand one thing clearly.

Concerning the discoveries of what you believe to be criminal activity, that you have sent to the Justice Department, were the criminal activities taking place in the thrifts engaged in these deals? Or, are you telling that there may be criminal activity in the deals themselves?

Mr. BOWSHER. Let me just check with my lawyer on that. [Pause.]

It basically was in the thrifts and not in the deals, Mr. Chairman. At least on the ones that we are referring.

The CHAIRMAN. The ones you have sent over.

Mr. BOWSHER. Yes.

The CHAIRMAN. But your work is continuing. You are not finished.

Mr. BOWSHER. We're pretty much finished with the referrals. In other words, we might have one more that we're still looking at. But, most of our investigative work has been referred.

The CHAIRMAN. Right. I wanted that clarification.

Senator Pressler.

Senator PRESSLER. Thank you, Mr. Chairman. Well, it looks like we have spent the Peace Dividend right here. [Laughter.]

Now, what does that really mean per year? Now, we see on your first page that FSLIC has closed its door with an $87 billion capital deficit. The estimation, as I understand it, is that the GAO estimates $400–$500 billion of loss, including the financing costs, over 30 years.

What's the real cost to taxpayers per year this year and next year, for example?

Mr. BOWSHER. Well, I think you'll have to get that from OMB. In other words, they have not at this point come up with their funding plan for these problems. And, of course, as it has been pointed out before, you're going to need more than what was originally legislated.

But, the timing does play into this as to when you need it, and what we need from the administration is a funding plan for the next couple of years, at least as to how much do they need.

And I think it gets back to the question that Senator Graham raised there about some of the cost of the funds, and things like that.

In other words, if we don't move expeditiously here, then we drive the cost of the overall program up.

So I am hoping that the funding that will be asked for by the administration will be adequate enough to allow the RTC to move forward and carry out the program that they have to do here as far as one taking over the institutions. Then handling the assets as they deem best.

Senator PRESSLER. In the Federal budget process, don't we usually try to avoid incurring costs this year and next year.

Mr. BOWSHER. Exactly. You're right.

Senator PRESSLER. We tend to rent buildings rather than buy them, which might result in higher cost.

But, here, your figures of $400–$500 billion include the financing costs over 30 years. And even now, because they're selling 40 year bonds, why do you have that additional estimate.

Mr. BOWSHER. You see, in other words, when the estimates were made last year, they were made on 30-year bonds. And now they have already sold some 40-year bonds and the plan is to sell some more. So it does include the interest out through that period.

Senator PRESSLER. But, if the Government could resolve all insolvent thrifts today with cash, without the need to finance it over 30 or 40 years, how much cash would it take?

Mr. BOWSHER. If you do it back to present value, which is what that basically is, it would be about $140 billion. But that's on the assumption that you could come up with $140 billion, not borrowing it but going out and either tax everybody immediately and raise $140 billion, or, you know, take $140 billion away from the Defense Department overnight and have it.

Then you could certainly reduce the cost.

Senator PRESSLER. Well, I think that is very significant. I think we really need to think about that funding mechanism. Our country with its huge deficit has gotten itself into circumstances——

Mr. BOWSHER. Absolutely.

Senator PRESSLER [continuing]. That the deficit aggravates this situation, or vice-versa.

Mr. BOWSHER. Yes, this really does aggravate all the projections, I believe, more so than most people realize, because, you know, when we are looking now at the plan, just using the CBO numbers, why, you're heading out to $4 trillion and $4.5 trillion of debt here in the mid-1990's. And that does not include most of these costs.

Senator PRESSLER. Well, I have been saying for my 16 years in Congress, and I haven't had too many listeners, that the deficit is the most dangerous thing that we have in our economy. Something could trigger a catastrophic event.

And I've been a prophet of doom all these years.

Mr. BOWSHER. I want you to know that, on my annual report this year to Congress, I put that right on the cover, that I thought the

deficit and the debt was the most compelling problem facing us. So I agree with you 100 percent.

Senator PRESSLER. And this report of yours indicates polices in financing that could trigger that catastrophic event in our economic history in terms of the debt coming home to roost, because this is a very startling report.

One question. How does $140 billion differ from the previous figures of OMB?

Mr. BOWSHER. The $140 billion is the present value of the $325 billion. In other words, if you look over here on the chart, we think that the $325 billion is the best estimate with the assumptions that the OMB people are using today, and everything like that, you would come up to $325 billion.

And if you did that on a present value basis, you would be down to the $140 billion.

Senator PRESSLER. Now, would you say that issuing those 40-year bonds is an act of irresponsibility?

Mr. BOWSHER. Well, I was always concerned about the off-budget financing which is driving us to the 30- and 40-year bonds for the RTC.

In other words, I thought it would be much better to do it through the Federal Financing Bank and do it as regular Treasury borrowing because it would be less cost to the taxpayer that way.

And I thought we were just kidding ourselves in the long-run that we could put this off-budget.

I always compare it to New York City. You know, in New York City, they had to balance their budget. And, yet, they went into bankruptcy for all practical purposes in the mid-1970's.

So people say how can you go into a financial crisis and still balance your budget every year prior to that?

It was because they moved their operating expenses, which they balanced, over to their capital budget. And then they sold bonds.

Well, if you think about what we did last year in this S&L crisis, we did the same thing. We took an operating problem and we literally bonded it out by putting it off-budget and selling these REFCORP bonds.

And so I think we're kidding ourselves long-term. They're still going to cost the American taxpayer, and it's going to cost more than if we had kept it on budget.

Senator PRESSLER. And I speak as the only Republican in the Senate who voted to keep it on budget—I think that was the proper vote. It was on the losing side.

Mr. BOWSHER. I think you'll see that as a better vote as each year goes by, Senator. [Laughter.]

Senator PRESSLER. I lost an invitation to a White House dinner but it's a vote I can brag about. [Laughter.]

Now, let me ask you one more thing.

You say that you advocate annual audits of insured institutions. And on page 15 of your report, you say the Federal Government, as insurer of deposits, has a tremendous potential exposure to loss, and so forth.

And you state there:

"Therefore, we have recommended, and continue to recommend, that insured institutions be required to undergo annual financial

audits and issue management reports on the effectiveness of internal controls and their compliance with safety and soundness laws and regulations. . . ."

This is a very costly proposal, especially for smaller insured institutions . . . banks, thrifts, and credit unions. Let me say this. Would an alternative, a potential alternative to your recommendations might be to consider random audits by the GAO of some insured institutions and reports to the Banking Committees of the Congress?

Mr. BOWSHER. No. We do not audit the institutions except on a special effort, because that's basically in the private sector. We think that the auditing should be done by the CPA firms, and it has to be done on an annual basis.

And I think why we put the extra emphasis on the review of internal controls in that is because, with modern computers, the assets are moving so fast that, if you don't have it on an annual basis, why, the thing can deteriorate.

And I think what happened here in a lot of these S&L's is that you had bad controls, bad paperwork, and the auditors would come in and finally work out a balance sheet and statement of operations with the management and audit it. But, the same weak controls, the same bad paperwork, the same bad loan files were there and the place went under before the next year came around.

So I think it's awfully important that we strengthen some of these audit procedures.

Now, I think your point is well-taken in that it's costly for the small institution. And as part of the legislation last year, there were some features there that didn't require everything of the small institution.

It's the bigger institutions that really hit the taxpayer.

In other words, in the small institutions that grow dramatically, go from being a $50 million institution to a billion dollar institution, those are the ones that have to have strong review by the Government regulators and by their CPA firms. And that's what we're trying to strengthen.

Senator PRESSLER. So I hear you saying that you would exempt my small insured institutions in South Dakota?

Mr. BOWSHER. I think your small S&L's could have some exemptions, that's correct, Senator.

Senator PRESSLER. OK, thank you very much.

We'll keep that in the record.

The CHAIRMAN. Thank you, Senator Pressler. We are going to let Mr. Bowsher out of here in just a minute. But first, I want to ask you one thing and then Senator Graham has something.

Then we will excuse you and keep your colleagues.

May we ask you to do an assessment of the financial strength of the FDIC Deposit Fund today, which is now the Consolidated Fund.

Mr. BOWSHER. Yes—no, you actually end up with different funds. We are also doing the audit of the FDIC fund for the banks. And we will do the audit when the new S&L Fund comes into being.

So we will be auditing these by separate funds, issuing separate audit reports.

The CHAIRMAN. Let me tell you what I am interested in obtaining, and you can tell me if you can get it for us.

We found that the FSLIC fund, whose final audit you are giving us today, capsized by a very substantial amount.

I would like to know exactly what is the strength of the FDIC Deposit Fund today. And I would like to know whether we ought to have any concern about it.

I would like to know how quickly you can give us an assessment. And I don't mean just today how much money is in the drawer——

Mr. BOWSHER. Yes, we are in the process of doing that review, Mr. Chairman. And we'll have that for you in June.

The CHAIRMAN. In June. Is there a set date?

Mr. BOWSHER. No. All audits always revolve around when we can get the information from the companies, or the institution. But we have most of the information now.

Bob is the auditor in chief of that work, too, so why don't you——

Mr. GRAMLING. Mr. Chairman, let me give you a brief status on where we are on the audit——

The CHAIRMAN. Well, let me do that in a minute.

Mr. GRAMLING. OK.

The CHAIRMAN. You are going to stay, when Mr. Bowsher leaves, so we will come back to you later.

Let's find out what Senator Graham wanted to ask Mr. Bowsher before we excuse him.

Senator GRAHAM. Mr. Bowsher, I wanted to go back to some of the questions that Senator Pressler was asking relative to the on-budget/off-budget question.

The information I have is that on the off-budget bonds there have been approximately $9.5 billion issued thus far. Is that correct?

Mr. BOWSHER. Yes, that is correct.

Senator GRAHAM. If my memory is correct, there were $30 billion of those bonds authorized. Is that correct?

Mr. BOWSHER. That is correct.

Senator GRAHAM. So that would indicate that we have $20-plus billion authorized but not yet committed. Is that correct?

Mr. BOWSHER. That is correct. And you also have a couple, $3 billion left of the FICO bonds, if you remember that off-budget effort.

Senator GRAHAM. Would you recommend that an attempt be made to deauthorize the current $20 billion of unutilized off-budget REFCORP financing and place that in an on-budget category?

Mr. BOWSHER. I would have to give that some thought, Senator. I am very much a big proponent of on-budget financing. Now that we have started down the road, let me do some thinking. I would like to get back to you on that, for the record.

Senator GRAHAM. Very good.

And, Mr. Chairman, if we do have a hearing with the various regulators, I would like them to be prepared to respond to that question.

[The response from Mr. Bowsher follows:]

As GAO has stated on numerous occasions, we are a big proponent of on-budget financing. Nonetheless, changing the financing mechanism at this point has its pluses and minuses.

Using Treasury borrowing is cheaper than using debt of an off-budget government sponsored enterprise [GSE]. For example, the last issuance of Resolution Funding

Corporation [REFCORP] bonds on April 10, 1990, sold at about a 35-basis point (with a basis point representing 1/100th of 1 percent) yield above comparable 30-year Treasury bonds. Further, we appear to be getting into a pattern of using GSE's, such as REFCORP and the Financing Corporation, to provide for payment of government obligations. We are concerned that if the practice of using off-budget GSE's to carry out Federal activities continues, budget discipline will be severely undermined. Such budgetary gimmicks make the deficit numbers look better, but hide the true picture and potentially postpone the day of reckoning.

However, after much debate, this off-budget financing mechanism was enacted, and through April 10, 1990, $13 billion in REFCORP bonds had been issued. Changing the mechanism at this time would entail various policy decisions and would certainly have budget (and Gramm-Rudman-Hollings deficit reduction targets) implications. Further, the legislation currently requires the industry, through the Federal Home Loan Banks, to provide the funds to back the $30 billion in REFCORP principal and to pay $300 million a year to help pay the interest on the bonds. This contribution more than offsets the difference between the cost of REFCORP bonds and comparable Treasury securities. Changing to Treasury financing might jeopardize this contribution and, therefore, ultimately result in higher costs to the taxpayers.

The CHAIRMAN. Mr. Bowsher, let us excuse you now.

Mr. BOWSHER. All right.

The CHAIRMAN. Thank you for your testimony. We will keep your colleagues here with us for a period of time, but your testimony has been very helpful to us today and we appreciate the good work.

Mr. BOWSHER. Thank you, very much, Mr. Chairman.

The CHAIRMAN. Let me just say, Senator Graham, with respect to the issue that arose on asking the various regulators to come in and tell us how they intend to deal with these increased estimates, we have an RTC oversight hearing scheduled for May 24. But in light of the data we have gotten today, as significant as it is, we will want to consider an earlier date than that.

We need to give the new Director of the OTS an opportunity to get suited up and get into a position to respond to our questions. Of course, there are other regulators to hear from where we could discuss how they intend to deal with the escalating numbers.

One of the things we need to pin down today is the assumptions that are built into the small chart you displayed. We need to pin down the assumptions that underlie those cost projections. Which assumptions were used to build the original estimates; and which you have now used yourself because you think are more realistic.

I will come back to that in just a minute, but I want to first settle the question of the strength of the FDIC Fund.

I would like you to tell me exactly what you are doing now, and whether you think that will be sufficient to our needs. Do we need to ask you to do something beyond that?

Mr. GRAMLING. OK. Thank you, Mr. Chairman.

Where we are now is at a very crucial point of the audit. The FDIC for the Bank Insurance Fund has recently closed its books for the last fiscal year, within the last 2 weeks. This is a critical time for us, because now the FDIC has set its reserves for the past assistance it has provided and, equally important, it is also really focusing now on troubled institutions and whether in fact it should be recording additional losses for the institutions that are likely to require assistance in the near future.

So the focus of our audit now is in the process of reviewing that work. Now as a piece of that work, and Mr. Fogel's Division is also doing preliminary work on the overall condition of the banking in-

dustry which we would take into consideration in trying to reach an opinion on the safety and the stability of the Insurance Fund, that work is going to take us about another month to finish.

Mr. FOGEL. If I could use an analogy that may help you, Senator, going back into the mid-1980's we were doing the same type of financial audit of the FSLIC Fund. We kept coming up and saying the fund was not in as good a shape as the people running FSLIC said it was in. We kept saying they should book more for the losses.

So we think that the type of financial audit that we are doing will enable us in June to comment on the stability and soundness of the Fund. So it would be a very analogous type thing, which should give you some good information at a particular point in time as to how sound it is.

The CHAIRMAN. So you are doing two things. You are auditing the Fund to see its actual performance through the end of last year.

Mr. GRAMLING. That is correct.

The CHAIRMAN. And you are doing a companion study to assess the strength and problems of the banking industry.

Mr. GRAMLING. That is correct.

The CHAIRMAN. Problems that could cause additional threats to the FDIC Fund. Is that right? You have got the two efforts going on?

Mr. GRAMLING. Concurrently.

The CHAIRMAN. Have you gone enough in either of those efforts to conclude that the FDIC Fund is perhaps dwindling? Is it going down in size? Are you concerned about stress on that fund?

Mr. GRAMLING. Not at this time.

The CHAIRMAN. Are you saying that you are not far enough along to conclude that? Or are you saying that there is no such a concern? Are you giving a neutral answer?

Mr. GRAMLING. We are very much concerned over the distressed institutions that you read about almost daily in the papers at this point, and especially in the Northeast Corridor where the downturn in real estate is having a significant impact.

The FDIC, as well as the GAO, have not finished the assessment of what that is going to do in relationship to the Fund balance. That is why I am hedging a little bit at this point to say which way is the Fund going—although obviously there are continuing losses that are going to have to be absorbed by the Fund. So I do not see the Fund in a growth pattern, if that helps to answer your question.

The CHAIRMAN. Yes.

Mr. FOGEL. One key difference, though, is that I think we have good relationships with all of the people at FDIC and we do not have any indication that they do not want to work with us——

The CHAIRMAN. Or that they are low-balling the numbers.

Mr. FOGEL. Yes. We do not have an indication of that.

The CHAIRMAN. I would be surprised if you did, because Mr. Siedman over the years has had a reputation of being a straight-shooter, which is very important.

I want to understand one other aspect of this. I am concerned about two things. I am concerned about what kind of shape the

Fund was in when we ended last year. You are coming down to the home stretch on that.

I am even more concerned about new stresses and pressures from the falling real estate values in several regions of the country. They may be putting new stresses on the banking system and on the Deposit Insurance System underneath it. I do not want to be an alarmist, but I am concerned about what I see.

I want to make sure that in doing our assessment we are not just looking back at last year, but are trying to do a dynamic assessment of the condition of the banking system today and its problems. We need some useful estimate of what is happening now and what may happen over the next 6 months, or through the remainder of 1990.

That is the concern I have at the moment. Are the two studies that you are doing likely to get right to that issue? Or should we give you a request that would sharpen your analysis so that you have both the charge and the charter to make that kind of an assessment?

Mr. FOGEL. Well, I think we should be able to make that assessment. We would be glad to work with you and the committee and give you a more extensive briefing on exactly where we are.

As you may recall, we are also doing a fair amount of work at the request of the committee in looking at the whole issue of Deposit Insurance reform and how all of this information comes together in terms of looking at the need to basically consider changing some of the structure in the financial services industry to perhaps better protect the Government's interest in terms of what we insure, and to what extent we are going to let institutions take risks with insured funds.

Let me just take it another step further. In round numbers, how much money do we have in the FDIC Fund today insofar as we know? I am not asking you for a precise figure, but money is drawn out, premiums go in, and so forth. What is an approximation of the current operating balance in that insurance fund?

Mr. GRAMLING. As of the close of the year, it is approximately $13.5 billion.

The CHAIRMAN. $13.5 billion. How many assets are supported by that $13.5 billion insurance fund?

Mr. GRAMLING. The ratio would certainly be less than the 1.25 percent. It would be in the neighborhood of somewhere around 0.85 percent.

The CHAIRMAN. That figure implies that this insurance fund is protecting about $2.1 trillion in assets?

Mr. GRAMLING. That is about right.

The CHAIRMAN. So we have got $2.1 trillion of the outstanding assets backed by Government insured deposits. Underneath that we have $13.5 billion in the Fund at the end of last year? Is that right?

Mr. GRAMLING. That is correct.

The CHAIRMAN. How substantial a cushion is that $13.5 billion to work from? There is money going into the Fund from deposit insurance premiums, and there is money coming out to deal with problem situations. Am I right in concluding that it would not take

very many large bank problems or failures to put a big dent in the fund, and maybe take it right down?

Mr. GRAMLING. Certainly four or five large institutions of the magnitude of $30 billion in assets would be a substantial blow to the Fund.

The CHAIRMAN. So we are getting down to a margin of 0.85 that is pretty thin. Is that not so?

Mr. GRAMLING. Approximately, yes.

The CHAIRMAN. Is that not a narrow margin to be working with?

Mr. GRAMLING. Given the state of the economy and the large institutions that are distressed out there now, we are very concerned.

The CHAIRMAN. What would happen if we got three or four banks that capsized in the next 12 months and that drew down the reserves to zero or below?

Mr. GRAMLING. We certainly do not want to see——

The CHAIRMAN. No, we do not want to see it. But what would happen if that were to take place?

Mr. GRAMLING. I think you are getting into a question that has been with us for quite some years, and that is really the "too big to fail" institutions, and how are we going to handle that problem. If they are smaller institutions, the Fund has the ability to handle those. When you get to the large institutions, as you correctly surmised, the Fund does not have the ability to handle many of those institutions on a concurrent basis.

The CHAIRMAN. Let me ask you one other thing. Where was the Fund at the end of 1988? Do you know, offhand? Does somebody with you know the balance?

Mr. GRAMLING. The Fund lost approximately $4 billion between——

The CHAIRMAN. No, but what would have been——

Mr. GRAMLING. About——

The CHAIRMAN [continuing]. How much of a reserve would have been there in the Fund at the end of 1988?

Mr. GRAMLING. It was around $14 billion.

The CHAIRMAN. So it would have been at a higher level, at $14 billion. You have not finished your work, but you think it may now be around $13.5 billion.

Mr. GRAMLING. For 1989.

The CHAIRMAN [continuing]. At the end of 1989?

Mr. GRAMLING. Yes.

The CHAIRMAN. But that is tentative. I want that stressed that that work is not completed.

Mr. GRAMLING. Right.

The CHAIRMAN. The advance study of the FDIC is relevant. The purpose of this hearing is to do the autopsy on the FSLIC, and how that fund proved not to be sufficient, and how we now deal with the aftermath.

So I think there is a very important—Senator Graham and I have talked about this any number of times both in the committee and outside the committee—that we develop a better capacity to see ahead than we have had before.

Understanding more clearly, in a dynamic fashion is now a principal requirement for policymakers in this town, whether they are in the executive branch, in the agencies, or here in the oversight

committees in Congress. While I do not want to set off any undue alarm, I want to understand what is happening.

I do not want to wake up one day and discover things that we had not anticipated and had not planned for, and made adjustments for. Then to be caught in the tumult of a situation out of control. That is what happened with respect to the S&L situation with its multiple causes.

It is our job now—and we are doing that job, with respect to other Government-insured activities. We have launched a series of inquiries, with GAO's help, to examine all the areas where the Government has outstanding guarantees to make sure that we do not have a time bomb ticking in somewhere—a bomb that has been hidden by accounting gimmicks, or papered over with budget gimmicks.

It is very important that we have an honest accounting of where things stand.

You wanted to say something?

Mr. CHAPIN. Yes, Senator, I agree with you thoroughly that it is necessary to stay on top of this and to monitor it closely. You can do some of that through careful review of the funds.

But it is also important to remember that the S&L crisis appeared partly and was identified late partly as a result of accounting and auditing problems down at the bank level. I think we have got some recommendations here today that Mr. Bowsher has laid before you that deal with the auditing side. We are going to be looking at those and looking at some of the accounting issues involved.

In terms of early warning, it is just as important to have the banks reporting the problems quickly and have the regulators identifying the problems quickly——

The CHAIRMAN. Right.

Mr. CHAPIN [continuing]. As it is to monitor the Fund.

The CHAIRMAN. Exactly. In fact, prompt information is all the more important, because it allows you to catch a problem earlier and stop it before a loss accrues.

Mr. CHAPIN. It runs right to the bottom. You have got to start with the banks——

The CHAIRMAN. Right.

Mr. CHAPIN [continuing]. And then work your way through.

The CHAIRMAN. I would like you to elaborate, and then I am going to yield to Senator Graham. I would like you to describe in detail some of the recommendations and ideas you have on auditing, and how the auditors and the regulators can work together to achieve coordination.

Could you run through them for us?

Mr. CHAPIN. Sure. I would like to do that.

I would, as a preface, say to you thought that the accounting issue is not addressed here. We will address that as soon as possible. That is also an important question. But let us deal with the auditing issues.

We have recommended that all banks be audited, and that the banks report on their internal controls and their compliance with laws and regulations.

We have also recommended that those reports be audited by the accounting profession.

Mr. Bowsher has suggested that there might be an opportunity to limit that to the larger institutions—obviously the bigger ones are the important ones.

We have also made recommendations that improve the relationships between the auditors and the regulators. It is very important, and you see this in some of the cases that you look at individually where the regulators and the auditors were working at cross-purposes. They really did not know what each of them were doing, and we can see that there would be a substantial improvement if there was good communication between them, even to the extent of recommending here that if the auditor spots a problem and cannot get the bank itself to take that to the regulator, that the auditor should go directly to the regulator and report the problem.

Now some people call this "whistle blowing," but I believe that we are now at the point where there is a public responsibility here on the part of the auditing profession with the Government's funds at stake, if they cannot get the message through, to come directly to the regulator with the problem.

I think we can see some examples where, had that happened, we would not have had at least the delayed recognition of the problems that we have all seen.

We also are recommending improvements at the board level. We would recommend an independent audit committee. By "independent," I mean independent in both fact and appearance. Some of the banks have boards that consist of substantial borrowers. We would like to see that board consist of independent directors.

We would also like to see the boards have a lawyer represented on the audit committee. There are legal issues here, and we think the legal perspective would be of substantial value to an audit committee in dealing with compliance problems and just generally with the complicated banking regulations that the audit committees need to be knowledgeable about.

We want to see the banks follow what is being done elsewhere when institutions report to the SEC. Namely, we would like to see the banks in their reports deal with risks and uncertainties that they face—something like the management discussion and analysis that the commercial companies have to provide now in SEC filings. We think there is room for that; that if the public and the regulators have a frank discussion of the risks and uncertainties a bank faces that cannot be accounted for but are in the future somewhere, that there would be a better understanding of the true position of those institutions. We think that is very important.

We are recommending mandatory peer review for the auditors. There is a mandatory requirement for firms that belong to the AICPA but it does not extend to all auditors, and we think that auditors need to have that kind of discipline. They need to be examined by their peers, and their procedures need to be scrutinized by someone who has the capacity to do so.

We have some recommendations that are somewhat controversial dealing with the larger money center banks. Those are the banks that can break the fund. So extraordinary requirements, we think, are possibly appropriate there. We are not quite ready to

make these recommendations without some further study, but what we have in mind is that on the larger money center banks that the regulator have the opportunity to appoint a second auditor. In effect, two auditors would approach these big banks. Two auditors together will put a better, stronger perspective into the examination.

I would explain to you that we have seen instances where auditors have not been able to stand up to the pressure of some of these larger institutions, and we think that having the regulator have an auditor appointed so that they can work together with the bank's appointed auditor would provide the courage to deal with some of these tough situations.

We are looking also for examinations quarterly. An audit is done on an annual basis. We think that in the money center banks that much could be gained if an auditor were to follow some limited procedures, do a review in effect of the quarterly statements. So if something is going wrong—and we have seen examples of this where banks have gone along and then suddenly fell apart in the middle of the year—that kind of situation should be spotted early in the larger money center banks.

Then last, we would recommend that in these cases that the regulators do more frequent on-site examinations. There are cases where the regulators are not there, and we would like to see them there in these critical situations. So that involves strengthening the regulator activity and getting more attention again at these larger banks.

The CHAIRMAN. I think these are very useful suggestions. But you have not finished your work on all of these. Some of these you are still considering?

Mr. CHAPIN. Right.

The CHAIRMAN. But all of these proposals go back to the idea of protecting the taxpayer exposure from Federal Deposit Insurance Guarantees. You do not intend to be intrusive, to snoop on the private sector; but you are trying to protect the public money, kept in a government-insured institution.

Mr. CHAPIN. That is right.

The CHAIRMAN. One might differentiate between a company that has government insurance and one that does not. An institution that has Government insurance is able to attract deposits because of the Federal guarantee. To safeguard taxpayers, you may well need an additional set of monitoring procedures, auditing procedures, beyond those normally found in the private sector. The unique nature of this fiduciary responsibility and the risk to the taxpayer requires an additional set of monitoring safeguards.

Mr. CHAPIN. You have expressed our view, exactly, Senator.

The CHAIRMAN. Now, I am sure there will be those out there who will not like that idea at all.

Mr. CHAPIN. That is right.

The CHAIRMAN. I remember one time we had an important banking figure—who I will not name—at the table, Senator Graham. He complained about Federal overregulation and the paperwork burden, and perhaps not without justification in some instances. In any event, he did not like the regulatory burden.

So I asked whether he was ready to give up deposit insurance. There was a long pause, and a lot of kind of squirming around in his chair, but he preferred to continue to have deposit insurance.

The question is what burden goes with insurance. This is especially true now, as you have told us today, we may be facing a half a trillion dollar bill for the hole blown through the old FSLIC fund. We have got an obligation to see that that kind of thing does not happen again. If that means additional auditing procedures, or changes in accounting methods, then I think it is time that these issues are taken up.

Let me say, before I yield to Senator Graham—that a year ago we included in our savings and loan legislation every single reform that the administration sent down to us.

Now a lot of people do not like that legislation because they think it is too tough and is forcing people out of business. But these people were doing things that were excessive and risky. Part of the reduction in size of the industry is occurring because we put a stop to a lot of bad practices—abuse of State powers; accumulation of junk bonds; excessive direct investment in real estate. These excessive risks are not allowed anymore. They are now illegal.

Other things may be needed, in the banking system, or even further tightening in the thrift industry to protect the deposit insurance funds. When it is clear what is needed, I will do everything I can to get them enacted. Whether by administrative ruling, or act of law, the necessary additional safeguards will be put in place.

So we are going to do everything we can to see that they are put in place.

Mr. CHAPIN. Senator, I would like to just say one more word on this. It is important that we proceed with our recommendations as promptly as possible. I think we cannot afford to let much time go by before we deal with these issues, the issues that I have just discussed and which you have so amply recognized.

The CHAIRMAN. I am in agreement with you.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I certainly concur in that. I think that maybe the greatest contribution of this hearing has been the sense of urgency that you have so dramatically communicated.

A concern that I have is what the congressional role should be in this matter. I would be interested in your comments as to what do you think we should have as our own auditing standards of the regulatory agencies to fulfill our public responsibility that they are fulfilling theirs?

Mr. FOGEL. Well, I think it is important first to look at it from a congressional standpoint and ask the first question: Are the agencies doing their job? The statutory framework is sufficient I think for them in most cases to carry out their work effectively. Part of it is a question of will. Part of it is a question of resources. Are they willing to come forth with information that is honest and not colored in a way to, for example, help deal with the budget deficit problem.

Generally then I would think that it is very important, and that is why we have got the recommendation in here though, to require the regulators to come up periodically and report to you all on the

situation. For example, that is why we have got the recommendations in here to present a cash flow analyses on a semiannual basis.

I think it is important for the GAO team to be able to go in and do the financial audits and report, and then ask the administrators in the agencies to come up and say what they want to do about it.

In a broader sense, though, I believe—and perhaps Don and Bob want to add to this—that it is important, too, for the Congress to be able, as you are doing, to be able to put these things in context. One of the things that concerns us is if you start looking at banks, if you look at the thrifts and other institutions, I think the question has to be asked: Is our regulatory system designed to deal with the modern financial institution today?

I mean, we have a system that was basically framed years ago and it did not take into account really all of the activities that go on today. It certainly did not take into account how quickly things have happened. I think a fundamental question has to be asked: Is our regulatory structure shaped in a way that allows the regulators to do the job that they need to do?

Mr. GRAMLING. Senator Graham, I would just like to add to that and embellish a point that Mr. Chapin just made a few minutes ago.

You really need to have better information for an early warning system. Part of the problems we operate with in doing financial audits of the Insurance Fund is that you want us to look at the condition of the industry. We are using quarterly data that is not audited, and as we have seen from the savings and loan crisis much of that information has proved to be not reliable. You have assets reported at values that are greatly inflated. We have unrecognized losses out there. And this is one of the problems that feeds back into why we are uncertain whether $325 billion is going to be enough over this period of time because the data is just not that good that is coming in.

As Don Chapin recommended, we need to do something out there to have some review of this quarterly data that is coming in so you can make better assumptions and analyses of what is really going on in the industry and have some comfort that you are using good information.

The CHAIRMAN. Thank you, Senator Graham.

There are two or three other things I want to cover before we finish this morning.

In 1988 we had three very successful thrift executives who were highly respected for running good, solid operations. They testified before our committee that limits to loans to one borrower helped to prevent fraud and abuse. This is what they said. They said: "One way that a financial institution can be looted by insiders is for it to make loans to directors or insiders who have no intention of paying the institution back. Regulations that limit the amount that can be loaned to a single borrower make it hard to significantly damage the institution through insider dealing."

Would you agree with that?

Mr. FOGEL. We have no problem with the limit to one borrower restriction. We are aware that it has caused some problems, but it is a safeguard that we think right now is important to have.

Mr. GRAMLING. Our own work at past failures in thrifts has indicated that where those past limitations were exceeded, the institutions continuously lost money based on that. So again we think a limit is appropriate.

The CHAIRMAN. In your testimony you express concern, and I quote, that "RTC has used a substantial amount of funds to replace high cost funds at conservatorships and to fund their liquidity needs." Are you suggesting that the RTC should not do this—that there is a better way for the RTC to use its limited resources?

Mr. FOGEL. No. That is a key thing that it needs to do quickly when it takes an institution over. I think one of our concerns is that the RTC needs to begin moving quicker now at deciding what it wants to do with institutions. In some cases, the institutions have been in conservatorship for a little longer time than we would like to see.

Now we recognize that RTC had a lot of start-up problems. They had to get their people. They had to get their procedures done. But we think that the time has now come that they need to move quicker. But we are not opposed to replacing high-cost funds.

The CHAIRMAN. We may give you some additional questions to respond to for the record. I know some of my colleagues also have some questions that they will want to have you respond to for the record.

In closing I want to make just one other comment about the three of you and also about Mr. Bowsher, who is now testifying before another committee.

I talked with a group of students yesterday from Michigan. They were here on a program called "Close-Up." I was talking to them about the importance of carefully planning their lives, making their professional decisions and choices—decisions that would prepare them for their work life.

I talked to them about the importance of public service, about doing the public's work, as an alternative to becoming an engineer, or a nurse, or joining any of the other professions normally in the private sector.

In the last decade, government service has taken an awful lot of knocks for several reasons—sometimes deserved, often not. There are many outstanding people that work in Government every single day. They do very important work and are among the most skilled people in our society. In many instances they could be out in the private sector earning far higher salaries. Yet, they remain devoted to doing the public's work, doing a public service.

I was struck today while you were testifying by the obvious quality that you represent professionally. You are serious people. You have been working at these jobs for a long period of time. You are doing them as well as you possibly can. You come in, you are well prepared, you are candid, and that is an enormous public service. It is something of great value to this country.

I see what is going on in Eastern Europe and other places, where people are trying to pull down totalitarian systems to get to a form of Democracy and citizen government. Then, I recall what you people very importantly represent—people who are willing to do the important work of government, and do it carefully, thoroughly, and objectively.

I think GAO is one of the finest arms of our Government, and you represent it well. Sometimes as we do our work around here, we do not pay enough attention to the people who do the work that is of enormous value to our country and to our people. These people are right at the center of the Democratic system. That is what citizen government is all about.

I want to thank you for your good work, and for the good examples that you set. I hope others, maybe younger people today, will think about careers in government themselves. Government is an important place to work. You can do valuable work here and be proud of it.

Mr. FOGEL. Thank you, very much, Mr. Chairman.

Mr. GRAMLING. Thank you, Mr. Chairman.

Mr. CHAPIN. Thank you, Mr. Chairman.

The CHAIRMAN. I thank all of you.

The committee stands in recess.

[Whereupon, at 11:38 a.m., the hearing was adjourned.]

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Resolving The Savings And Loan Crisis: Billions More and Additional Reforms Needed

Statement of
Charles A. Bowsher
Comptroller General of the United States

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL
OF THE UNITED STATES

We have completed our audit of the Federal Savings and Loan Insurance Corporation's (FSLIC) final financial statements as of August 8, 1989. After losing $100 billion from 1984 through August 8, 1989, FSLIC has now closed its doors with an $87 billion capital deficit--the largest ever reported by a public or private corporation. These statements raise the important issue of how much money will be needed to resolve the savings and loan crisis.

In July 1989, the Office of Management and Budget (OMB) issued budget outlay projections from which we estimated that $257 billion would be needed over 33 years to pay off FSLIC's obligations, resolve the problems of institutions awaiting resolution, pay interest on the $30 billion in bonds the Resolution Funding Corporation (REFCORP) was to issue, and pay some administrative expenses.

Based on revised estimates of the net cash outlays needed for FSLIC's assistance transactions and for unresolved institutions, the Resolution Trust Corporation's (RTC) estimates of its administrative expenses and interest costs on borrowed funds, and our analysis of the actual interest costs for REFCORP bonds issued through January 1990, we estimate that at least $68 billion more, or a total of $325 billion, will be needed.

This $68 billion increase is allocated as follows.

-- $12 billion more for institutions that have received FSLIC assistance.

-- $13 billion more than the $50 billion provided for troubled institutions that RTC must resolve.

-- $10 billion for RTC administrative expenses.

-- $28 billion for interest on funds RTC borrows for working capital purposes.

-- Almost $5 billion in additional interest expense for the $9.5 billion in REFCORP bonds issued through January 1990.

This $325 billion estimate is a "least cost" estimate based on present conditions. The estimates of net cash outlays for institutions that received FSLIC assistance and institutions that had not been resolved as of August 8, 1989, are still subject to significant change. In particular, RTC's costs to resolve troubled institutions will likely be higher than estimated. Also, this estimate is still based on OMB's optimistic

assumptions regarding interest rates for the remaining $20.5 billion in REFCORP bonds.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provided mechanisms to pay for the costs to resolve the crisis. FIRREA authorized Treasury appropriations to cover certain costs, such as those related to FSLIC's assistance transactions and REFCORP interest, not paid from other sources.

However, FIRREA only authorized $50 billion for RTC resolutions and administrative expenses. Therefore, we are recommending that the Chairman of the RTC Oversight Board, in consultation with the Chairman of the Federal Deposit Insurance Corporation (FDIC), develop proposals to provide the additional funds RTC will need.

We believe that it is vitally important to provide the taxpayers a complete and accurate accounting of the costs to put the savings and loan crisis behind us. We are, therefore, also recommending that the Chairmen of the RTC Oversight Board and FDIC jointly report at least semi-annually to the Congress on the total cash needs, net costs, and sources of funds necessary to cover FSLIC's obligations, RTC's resolutions, and related costs.

Although funding proposals must be developed, RTC should not delay resolution actions while they are being developed. It has funds available under FIRREA. RTC should begin to quickly resolve institutions to minimize the ultimate costs. We note that RTC has used a substantial amount of funds to replace high cost funds at conservatorships and to fund their liquidity needs. Although we appreciate the need for RTC's extended conservatorship program, we have some concerns about the management of conservatorships.

Other work we have done over the last several years points to the need for the Department of Justice to continue to pursue enforcement actions against those individuals who violated laws and regulations and thereby contributed to the massive losses of savings associations and the deposit insurance fund.

Our work also shows a need for required annual audits of insured institutions and reports on their internal controls and compliance with laws and regulations. We also believe that certain other steps should be taken to improve the quality of audits and to enhance the financial and other information that insured institutions submit to the regulators. Further, consideration should be given to augmenting auditing and on-site examination requirements for large institutions that, if they failed, would result in a significant loss to the deposit insurance funds.

Mr. Chairman and Members of the Committee:

We are pleased to be here today. You requested that we discuss the results of our financial audit of the Federal Savings and Loan Insurance Corporation's (FSLIC) final financial statements dated August 8, 1989. These statements sum up the known financial losses of the savings and loan industry crisis to FSLIC and are summarized in attachment I.

For the 7 plus months ending August 8, 1989, its last day of operation, FSLIC reported a net loss of over $13 billion. This loss is in addition to its $66 billion loss in 1988, and another $21 billion in losses it incurred from 1984 through 1987. After losing $100 billion since 1984, FSLIC has now closed its doors with a capital deficit of $87 billion--the largest ever reported by a public or private corporation. FSLIC's financial statements raise the important issue of how much money will be needed to resolve the savings and loan industry crisis which my testimony will address.

FUNDS NEEDED TO
RESOLVE THE CRISIS

In July 1989, the Office of Management and Budget (OMB) issued budget outlay projections from which we estimated that $257 billion would be needed over 33 years to pay off FSLIC's obligations, resolve the problems of institutions awaiting resolution, pay interest on the $30 billion in bonds the

Resolution Funding Corporation (REFCORP) was to issue, and pay some administrative expenses.[1] This estimate was based on OMB's assumptions regarding future interest rates, the general state of the economy, and recoveries on assets of troubled institutions.

Based on our revised estimates of the net cash outlays needed for FSLIC's assistance transactions and for institutions that the Resolution Trust Corporation (RTC) must resolve, RTC's estimates of its administrative expenses and interest costs on borrowed funds, and our analysis of the actual interest costs on the bonds REFCORP issued through January 1990, at least $68 billion more, or a total of $325 billion, will be needed. (See attachment II.)

The $68 billion increase is allocated as follows.

-- $12 billion more for institutions that have received FSLIC assistance. In July 1989, OMB estimated that almost $56 billion would be needed during fiscal years 1989 through 1999 to pay for FSLIC's assistance transactions. Based on our review of FSLIC's assistance transactions, we estimated that about $68 billion would be needed during the same period for those transactions.

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[1]Financial Audit: Federal Savings and Loan Insurance Corporation's 1988 and 1987 Financial Statements (GAO/AFMD-90-34, October 31, 1989).

The increase is primarily due to (1) the value of assets being lower than originally estimated, and (2) guarantee payments being higher than originally estimated because assets are not expected to be sold as early as previously assumed.

-- $13 billion more than the $50 billion that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provided for troubled institutions that RTC must resolve. Based on our audit, we estimated that $63 billion would be needed to resolve the problems of 560 institutions with $277 billion in assets and negative tangible net worth of $31 billion. The increase is primarily due to higher estimates of expected continuing operating losses and to an increase in the number of institutions that will need to be resolved.

-- $10 billion for RTC administrative expenses. RTC estimates that its administrative expenses for 1990 alone could be as much as $1.6 billion. Based on that estimate, RTC's administrative expenses through December 31, 1996, the date FIRREA calls for RTC's termination, could be as much as $10 billion or more.

-- $28 billion for interest on funds RTC borrows for working capital purposes. In its January 1990 cash flow

projection, RTC estimated that interest costs on $87 billion of borrowed funds would exceed $28 billion through fiscal year 1998. RTC's working capital needs, and the related interest costs, depend on numerous factors, such as the types of resolution actions used and the timing of recoveries from asset sales. Therefore, it is difficult to estimate how much working capital RTC may ultimately need.

-- Almost $5 billion in additional interest expense for the $9.5 billion in REFCORP bonds issued through January 1990. Most of this increase results from an additional 10 years of interest because REFCORP issued $5 billion in bonds with terms of 40 years instead of 30 years as OMB assumed. The rest of the increase was due to the average actual interest rate on the bonds exceeding the interest rate OMB assumed.

This $325 billion estimate is a "least cost" estimate based on present conditions. The estimates of net cash outlays for institutions that received FSLIC assistance and institutions that had not been resolved as of August 8, 1989, are still subject to significant change. In particular, it is highly likely that RTC's costs to resolve troubled institutions will be higher than $63 billion. The actual costs depend on various uncertainties, such as the extent of continued operating losses, the quality and

value of the assets in assisted or troubled institutions, future interest rates, the potential effect of FIRREA, and the economic outlook for certain sectors of the economy. Also, our estimate of RTC resolution costs is based on 560 institutions. If more institutions require resolution, the costs will increase. Further, the $325 billion estimate is still based on OMB's optimistic assumptions regarding interest rates for the remaining $20.5 billion in REFCORP bonds.

ACTIONS NEEDED TO PROVIDE FUNDS

With costs running at least $68 billion higher than previously estimated, the question that has to be addressed is, "What needs to be done?" As discussed, the estimated net cash outlays required to pay off assistance agreements into which FSLIC entered have increased by $12 billion over OMB estimates for FIRREA. However, FIRREA included a mechanism to pay for all of FSLIC's obligations, which were transferred to the FSLIC Resolution Fund. The necessary funds will come from a variety of sources, including the remaining funds authorized by the Competitive Equality Banking Act of 1987; sales of assets in FSLIC receiverships; and insurance premiums assessed against savings institutions until the end of 1991 not needed by the Financing Corporation, REFCORP, or the new Savings Association Insurance Fund. Any additional funds needed are to be provided through Treasury appropriations.

Interest costs on the bonds REFCORP issued through January 1990 will be almost $5 billion higher than OMB assumed. However, FIRREA also included a mechanism to pay for REFCORP's interest expenses. The necessary funds will come from a variety of sources, including earnings on assets of REFCORP not needed to back the principal of the bonds it issues, liquidating dividends and payments RTC receives from receiverships not needed for resolutions, any proceeds from warrants and participations acquired by RTC, and up to $300 million per year from the Federal Home Loan Banks. To the extent the funds available from other sources are insufficient, Treasury is to pay the additional amount due.

On the other hand, FIRREA provided RTC $50 billion to resolve institutions placed into conservatorship or receivership between January 1, 1989, and August 9, 1992, and to pay administrative expenses. As previously discussed, RTC needs an additional $13 billion for resolutions, $10 billion for administrative expenses, and $28 billion for interest costs on working capital funds. Therefore, RTC's costs will likely exceed $100 billion.

Providing the shortfall between the $50 billion FIRREA authorized and the amount of funds RTC will need will require legislation. We believe that the Chairman of the RTC Oversight

Board, in consultation with the Chairman of the Federal Deposit Insurance Corporation, needs to develop proposals to deal with the current total shortfall for resolutions, administrative expenses, and interest costs on any working capital funds RTC borrows.

TREASURY'S SHARE OF THE COSTS

Based on OMB's July 1989 funding summaries, we estimated that Treasury's share of the $257 billion would be $139 billion. We cannot estimate Treasury's share of the $325 billion, other than to say that it will be higher than $139 billion. Decisions must be made regarding how to raise the additional funds RTC will need. Also, the administration has not revised its estimates of the amount of funds that will be provided from sources other than Treasury.

The taxpayers are having to pay billions of dollars to resolve this crisis. Therefore, it is vitally important that we provide them a complete and accurate accounting of all the costs to put this crisis behind us. However, responsibility for resolving troubled institutions, paying off FSLIC's obligations, and establishing a new insurance fund for savings institutions is spread among various entities and funds. No one entity is tasked with keeping track of the costs and how we are paying for them. Therefore, we believe that the Chairmen of the RTC Oversight

Board and the Federal Deposit Insurance Corporation need to jointly report at least semi-annually to the Congress on the revised total cash needs, net costs, and sources of funds to pay for FSLIC's obligations, RTC's resolutions, and related costs.

It should be noted that the estimated cost to resolve the crisis does not include any interest that Treasury would incur on funds it would have to borrow to provide its share of the total funds needed. The Congressional Budget Office and OMB consider general Treasury interest costs to be secondary program costs and they account for them at the aggregate level for all Treasury borrowing. They do not attribute Treasury's interest costs to any particular program. Clearly though, Treasury's interest costs will be substantially higher than they would have been if Treasury had not had to provide funds to resolve the savings and loan crisis.

COMMENTS ON RTC OPERATIONS

Although it is important to provide the additional funds RTC will need, RTC should not delay resolution actions while new funding proposals are being developed. RTC has funds available under FIRREA. Also, the issue of how to raise working capital is apparently resolved (through borrowing from the Federal Financing Bank). Therefore, RTC should have sufficient funds to start aggressively resolving the problems of institutions currently in

conservatorship. In that regard, we should note that, to date, RTC has used a substantial amount of funds to replace high cost funds at conservatorships and to fund their liquidity needs. Delaying resolution actions, even when the institutions' cost of funds is reduced, is costly. Operating losses of insolvent institutions have significantly increased the cost of resolving troubled institutions. Therefore, it is imperative that RTC begin to quickly resolve troubled institutions to minimize the ultimate costs.

Nonetheless, we appreciate the need for and utility of RTC's extended conservatorship program. Indeed, under RTC's conservatorship program, partial liquidations are occurring prior to actual resolution. We do, however, have some concerns about the management of the conservatorships.

In testimony given earlier this week, we expressed concern about the turnover of managing agents in the conservatorships, the lack of guidance being given to RTC's regional offices and the conservatorships themselves on how best to "downsize" and manage institutions, and the lack of training for RTC managing agents.[2] We also expressed concern about the fact that RTC still has not finalized its plans and procedures for managing and disposing of assets.

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[2]Failed Thrifts: Resolution Trust Corporation and 1988 Bank Board Resolution Actions (GAO/T-GGD-90-29, April 2, 1990).

I would now like to change focus somewhat to discuss other issues we think should be addressed to deter a future problem of this magnitude. To do so, it is important to understand how so many savings institutions failed.

CAUSES OF SAVINGS ASSOCIATIONS FAILURES

The savings and loan industry has been experiencing severe financial difficulties since the early 1980s. In 1981 and 1982, the industry lost almost $12 billion in equity capital because extremely high general interest rates forced institutions to pay high interest rates to fund their operations. At the same time, they were encumbered with low-yielding, long-term loan portfolios. Also, regulators did not act decisively to close failed savings institutions. Instead, they reduced capital standards, allowed institutions to use accounting gimmicks to artificially inflate reported capital, and even granted forbearance from the relaxed capital standards.

During this same period, many institutions were allowed to diversify their investment activities into potentially more profitable, but risky, activities. Many of these activities were only economically viable if inflation in real estate values continued. When this did not occur, many institutions started to fail. In many cases, institutions which chose to diversify also

had serious internal control deficiencies and failed to comply with laws and regulations. Thus, the risk of these activities was increased.

Our work on the causes of savings associations failures[3] showed that the regulators noted numerous and often blatant violations of laws and regulations at the 26 failed institutions we reviewed. For example, even before FIRREA, federal regulations limited amounts an institution could lend to one borrower. One regulation stated that outstanding loans to one borrower should not exceed, in the aggregate, the lesser of 10 percent of a savings institution's withdrawable accounts or an amount equal to the institution's regulatory capital. Another regulation limited the amount of commercial loans to one borrower to 15 percent of the institution's capital and surplus.

These regulations were designed to avoid situations in which an institution's financial condition is dependent on the financial viability of any single borrower. Twenty-three of the 26 institutions we reviewed violated the loans to one borrower regulations. In some cases, after examiners informed them that loans to some borrowers exceeded the limitations, institutions continued to lend more money to the same borrowers.

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[3]Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

The institutions we reviewed also engaged in underwriting practices which were not necessarily in violation of regulations, but were considered unsafe by examiners. For example, institutions lent to borrowers who had little or no equity in property or projects and lent amounts that equaled or exceeded the purchase price or the appraised value of collateral. In some cases, examiners noted that borrowers not only had no funds of their own invested, but also personally received a portion of the funds when the loans were made. These arrangements are referred to as "drag loans" because the borrower "drags away" part of the proceeds. Ultimately, much of the funds have been "dragged away" from FSLIC and the taxpayers.

During our review, we also found that indications of fraud and insider abuse were evident at all of the 26 institutions. For the institutions we reviewed, the former Federal Home Loan Bank Board had made 85 criminal referrals related to insiders and other improprieties which were believed to have contributed to the demise of the institutions. These referrals involved 19 of the 26 institutions we reviewed, and contained allegations of 179 violations of criminal law, including conspiracy, theft, embezzlement, willful misapplication of funds, and fraud.

During our review of FSLIC's 1988 assistance transactions, we also became aware of several allegations of misconduct. For

example, examiners found that one acquired institution, in a series of transactions, loaned over $40 million to the cousin of the institution's Chairman of the Board of Directors. The amount lent to the cousin violated the loans to one borrower regulations. After receiving the loans from the institution, the cousin loaned the Chairman $250,000. This matter is now being investigated by the Federal Bureau of Investigation.

In another case, we found that, due to lax supervision, FSLIC may have been the victim of false submissions by an asset management contractor regarding the sale and repurchase of time-share units. We have referred information on this and other matters to the Department of Justice for further investigation.

The RTC Chairman has recently testified that about 60 percent of RTC-controlled institutions have been victimized by serious criminal activity. He said that RTC plans to have a staff of 300 investigators by the end of the year to help determine whether and what actions should be initiated against individuals who caused savings institution insolvencies through their negligent and reckless mismanagement, fraud, or criminal conduct. He noted that over 1,200 criminal referrals have been sent to the Department of Justice naming insiders, borrowers, or agents of RTC-controlled institutions.

We believe that additional investigation by law enforcement agencies will reveal further evidence of fraud and mismanagement. FIRREA authorized additional funds for the Department of Justice, increased civil and criminal penalties, and required Justice to establish a regional fraud office to address fraud and abuse that often accompanied the failures of savings institutions. Investigating these matters is an important task. It is essential for Justice, as the agency charged with criminal law enforcement, to investigate and prosecute those who have improperly benefitted from their activities. We must send a strong signal to directors and officers of insured institutions and to contractors with RTC and others that such practices will not be tolerated.

Accounting and Auditing Issues Need to Be Addressed

FIRREA included many needed reforms to prevent the abuses of the past from recurring. It increased capital requirements, limited the activities of insured savings institutions, and strengthened supervision and enforcement tools. Nonetheless, with all FIRREA's improvements to strengthen regulation and enforcement of insured institutions, I am concerned that some important accounting and auditing issues were not addressed. We are currently reviewing whether generally accepted accounting principles provide regulators with adequate early warning of institutions' financial difficulties. We will be reporting on

that issue later this year. Today, I would like to discuss one issue that is vitally important to ensuring the success of FIRREA's reforms--improved auditing and on-site examination.

The federal government, as insurer of deposits, has a tremendous potential exposure to loss if it must honor those deposits, as it is now having to do for savings associations. But, in many cases, regulators and the deposit insurer lack the necessary financial and other information to assess institutions' financial condition and the adequacy of their internal controls and compliance with laws and regulations. Insured institutions must be required to provide better information in these areas. Therefore, we have recommended,[4] and continue to recommend, that insured institutions be required to undergo annual financial audits and issue management reports on the effectiveness of internal controls and their compliance with safety and soundness laws and regulations. To provide assurance on the validity of the management reports, we also recommend that, as part of the annual audit, auditors be required to review and report on management's assertions contained in its reports.

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[4]Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989); and Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

In our March 7, 1990, response to the Treasury's request for comments on issues under its study of the deposit insurance system, we also supported establishing a closer working relationship between regulators and auditors of insured banks and savings associations. As part of the overall concept, we supported the following.

-- Reporting the results of any audit of an insured institution to the regulators.

-- Requiring regulators to share reports on an institution with its auditors, with exceptions to cover sensitive situations such as those involving litigation and ongoing actions or investigations.

-- Auditor participation in conferences with the regulators and the insured institutions. The responsibility should be on the regulator or the institution to request that the auditor attend meetings. Auditor participation in conferences should also be balanced with appropriate protection for the auditor from liability for disclosing information which might otherwise contravene any duties to the client.

We also supported the concept of authorizing auditors to communicate in good faith to the regulators information they

became aware of in their capacity as auditors without being regarded as having contravened any duty to their clients. However, the institution should continue to be the regulator's primary source of information. The responsibility to provide the regulators with information should be placed on the auditor only when the institution fails to report the information or the auditor no longer has confidence in the institution's directors or senior management. In such situations, the auditor should first attempt to report the information through the institution's audit committee.

We also recommended to the Treasury that it consider in its study several other auditing and on-site examination improvements, including the following.

-- Requiring institutions to enhance disclosures on the risks and uncertainties facing them in their annual reports. Such information would help the regulators and others make better decisions on the areas of operations that deserve additional supervisory focus and on the continued viability of the institutions.

-- Requiring institutions to establish audit committees, which play an important role in preventing and detecting fraudulent financial reporting and overseeing internal controls. Members of an institution's audit committee

should be independent in fact and appearance. Further, to provide a legal perspective on the application of laws and regulations and the relevant procedures to achieve compliance, institutions should be required to have at least one independent attorney on the audit committee.

-- Requiring mandatory peer reviews for all auditors of insured depository institutions. Peer reviews help ensure that auditors maintain high quality operations and adhere to professional standards.

-- Augmenting auditing and on-site examinations for money center banks and other large insured institutions which, if they fail, would cause a significant drain on the insurance funds. We proposed several options for further study and consideration, including allowing regulators to appoint an auditor to conduct a joint audit of the institution with the auditor appointed by the institution, requiring that the quarterly financial information submitted to regulators be reviewed by an auditor, and requiring more frequent, on-site regulatory examinations.

CONCLUSIONS

The American taxpayers are having to pay billions of dollars to resolve the savings and loan crisis. We owe it to them to vigorously go after those who helped cause the crisis. We also need to take whatever steps are necessary to prevent another crisis of this magnitude. Positive action to identify, correct, and prevent the internal control and compliance abuses of the past is crucial. At the same time, the RTC Oversight Board and the Federal Deposit Insurance Corporation also need to develop proposals to deal with the shortfall between the funds authorized by FIRREA to resolve troubled savings institutions and the funds that will be needed.

RECOMMENDATIONS

Based on our audit and review, we recommend that

-- the Chairman of the RTC Oversight Board, in consultation with the Chairman of the Federal Deposit Insurance Corporation, begin developing proposals to deal with the current total shortfall between the $50 billion FIRREA provided and the amount of funds RTC will need for resolutions, administrative expenses, and interest costs on any working capital funds RTC borrows; and

-- the Chairmen of the RTC Oversight Board and the Federal Deposit Insurance Corporation jointly report at least semi-annually to the Congress on the revised total cash needs, net costs, and sources of funds to pay for FSLIC's obligations, RTC's resolutions, and related costs.

Mr. Chairman, this concludes my prepared statement. I will be pleased to respond to any questions you or members of the committee may have.

ATTACHMENT I

ATTACHMENT I

Federal Savings and Loan Insurance Corporation
Summary Statement of Financial Condition
August 8, 1989 and December 31, 1988
(Dollars in billions)

	August 8, 1989	1988
Assets		
Cash and investments	$ 2.5	$ 3.7
Claims against assets acquired from closed institutions, net	5.8	5.9
Loans and other assistance to insured institutions, net	1.3	1.5
Corporate assets held for liquidation, net	1.3	1.3
Other	0.1	0
Total Assets	$ 11.0	$ 12.4
Liabilities		
Accounts payable and other liabilities	.2	.1
Notes payable to Federal Home Loan Banks	.8	.8
Notes and interest payable to insured institutions	19.6	20.3
Estimated liability for assistance agreements	22.0	22.6
Estimated liability for unresolved cases	55.2	43.6
Total Liabilities	$ 97.8	$ 87.4
Insurance Fund Reserves (Deficit)		
Capital in the Financing Corporation	7.5	5.9
Accumulated Losses	(94.3)	(80.9)
Capital Deficit	$(86.8)	$(75.0)

Source: GAO summary of FSLIC consolidated financial statements.

ATTACHMENT I

ATTACHMENT I

Federal Savings and Loan Insurance Corporation
Summary Statement of Income and Expenses
August 8, 1989 and December 31, 1988
(Dollars in billions)

	August 8, 1989	1988
Income		
Premiums	$ .6	$ 1.5
Interest income	.2	.3
Other	.1	.6
Total Income	.9	2.4
Expenses		
Administrative and other	.2	.2
Interest	1.1	.6
Provision for loss on claims against assets of closed institutions	0	2.8
Provision for loss on assistance transactions	1.3	38.4
Provision for loss on unresolved cases	11.7	26.4
Total Expenses	14.3	68.4
Net Loss From Operations	$(13.4)	$(66.0)

Source: GAO summary of FSLIC consolidated financial statements.

ATTACHMENT II

ATTACHMENT II

Minimum Funds Needed to Resolve The Savings and Loan Crisis

(All amounts in billions)

Estimate Based on OMB's July 1989 Funding Summaries:		
FSLIC Assistance Transactions	$ 56	
RTC Resolutions	50	
REFCORP Interest Expense	69	
Financing Corporation (FICO) Interest Expense	31	
Establish Savings Association Insurance Fund (SAIF)	9	
Post-RTC Resolutions	24	
Non-RTC Administration and Other	9	
Subtotal - Direct Funding Needs	248	
Lost Tax Revenues From FSLIC Transactions	9	
Total Based on OMB's July 1989 Estimates		$257[a]
Additional Funds Needed For:		
FSLIC Assistance Transactions	$ 12	
RTC Resolutions	13	
RTC Administrative Expenses	10	
Interest on RTC Working Capital	28	
Additional REFCORP Interest Expense	5	68[b]
Minimum Funds Needed		$325

[a]This estimate is based on OMB's estimates of the funds needed during fiscal years 1989 through 1999. However, funds will be needed in later years to pay interest on REFCORP and FICO bonds. OMB assumed that they would issue 30-year bonds. Therefore, our estimate included the entire amount of interest that would be incurred over the 30-year life of the bonds.

[b]These additional funds will be needed over different periods of time. Most of the funds ($63 billion) will be needed before the end of fiscal year 1999. The additional interest is primarily due to an extra 10 years of interest because REFCORP issued 40-year bonds instead of 30-year bonds.

Source: OMB July 1989 funding summaries and information from FSLIC, FDIC, RTC, and REFCORP.

30-545 (64)

GAO Minimum Funds Needed to Resolve the Savings and Loan Crisis

(in billions)		
GAO Estimate based on OMB's July 1989 funding summaries		**$257**
Additional funds needed for:		
FSLIC Assistance Transactions	$12	
RTC Resolutions of Failed Institutions	13	
RTC Administrative Expenses	10	
Interest on RTC Working Capital	28	
Additional REFCORP Interest Expense	5	68
Minimum funds needed		**$325**